

Luxembourg, September 15th, 2006

Pre and post-trade transparency provisions of the Market in Financial Instruments Directive in relation to transactions in classes of financial instruments other than shares

Who we are

1. The Luxembourg Bankers' Association is the representative body of Luxembourg's banks but also of financial sector's other professionals including law and audit firms. ABBL missions are the protection and development of the professional interests of its members in the broadest sense as well as the promotion the Luxembourg financial centre.

General statement

2. ABBL welcomes the opportunity offered by this call for evidence to present the Luxembourg banking community's views regarding the proposal.
3. Our first comment regards the timing for the revision. Although it is set by article 65 of the 2004/39/EC directive, MIFID only enters into effect on 1/11/2007 so that its requirements have not been implanted nor tested yet.
4. We undertook a review of the literature as well as conducted interviews with our members. The conclusion we draw is that extending pre & post trade requirements beyond current practices is at least not convincing be it from an Investment Firm or client perspective. The market is functioning quite well, volumes are good, spreads are tight (compared to the US), which was also pointed out and acknowledged by CESR following the wholesale business day¹.
5. Transparency requirements have to be market specific, they evolved following different paths depending on the products. The very nature of the markets where these rules should be applied should not be underestimated or overlooked, thus an extension of MiFID pre & post trade transparency rules to other instruments than shares looks simplistic. Concretely the price formation process in the bond market or other non-equity type products is completely different from equity markets, which means that rules applying to equity could not be transposed without major adaptation to other markets. If new transparency requirements were applied liquidity, transparency as well as prices would be directly affected in dramatic ways, which would not necessarily be positive for the market or the retail clients. Moreover current literature does not point out specific cases of non-efficiency that would be solved through new transparency requirements.
6. Introducing pre or post trade transparency should also be balanced by a sound costs and benefits analysis both at micro and macro level, in addition to any consideration of the impact on the market. The impact of the application of EU wide transparency measures to non-equity markets will at a micro level completely change the price formation process and the structure of most investment firms or banks to deal with new rules, and then at a macro level the impact of new measures remains unclear regarding the consequences for the issuers. Transparency mechanism parallel to shares would be introduced at costs that could be huge as such

¹ CESR 06-247: report on CESR's wholesale day

structure have not been developed currently there is no such a structure developed within banks or information providers to ensure a smooth and efficient communication of relevant information, and it would be rather difficult to have one in the short or medium term.

7. Ideally for the reasons mentioned above, we call for a non-intervention, unless clear and proven market failures are demonstrated. We would also call for no intervention given the large and diversified consensus of both practitioners and researchers pointing to the current satisfactory state of transparency and efficiency of the non-equity markets and in the end because the outcomes of a costs/benefits analysis remains unclear be it for the markets or for clients. We would at the very least require postponing any recommendation regarding extension of pre or post trade transparency requirements until MIFID has had enough time to show its effects on the market.

Answers to questions

8. *Q1. Do you have comments on the proposed scope of the report?*

We are not surprised that this report realises that each asset class must require specific transparency rules. Non-equity markets are not homogenous both in terms of structure and nature and thus new rules, if any, should be tailored accordingly.

But this doesn't solve the main problem, even if different asset classes have been identified, it does not mean per se that transparency requirements should be modified. Furthermore the report does not identify any reason to require any change, it does not either consider the costs and benefits associated with new requirements. Before any further action is taken at least a due costs/benefits analysis should be undertaken for each identified class to strike the best balance for the market and clients.

9. *Q2. Do you consider this classification scheme to be sufficient for the purpose of the review?*

Each category seems to regroup major asset classes beyond equity, nevertheless from our point of view a staged approach would only be a solution after achievement of an impact analysis and thus a demonstrated need to modify pre or post trade transparency requirements.

10. *Q7. To what extent are non-equity financial instruments different from equities so that lower levels of transparency in those markets may be justified?*

We would not talk about lower level of transparency but different levels. Current levels of transparency are set by the users and not necessarily by regulation, but are efficient according to users.

As the transparency we know today was the product of evolution; it exactly covers the specific needs of each asset class market. Today for example bonds are completely different instruments compared to equities. Equity is a stake in the capital of a company which represent both obligations and rights for its holder, whereas bonds are issued to finance part of the activity and do generally not entitle its holder rights (or obligations) on parts of the company. Thus because of the different nature of the instruments, the market is different, capital is issued once (except in case of increase) whereas bonds could be issued on a regular basis and for a definite life span as well as have more fixed features (like coupon, maturity...), a company could thus have numerous bonds with different maturities issued at the same time and with different conditions of seniority attached to it, when it has only one capital.

A lot of bonds are bought in the primary market and kept until maturity, which takes at the outset some "available liquidity" out of the market most of the time for a longer period than shares, only then the remaining portion could be sold on the secondary market. On the secondary market there are so many different issues even per issuer that applying requirements for shares would cause a problem. Most bonds are currently traded in the most optimistic scenario 2 to 3 times a day (for the liquid ones), which compared to equity is very low. Another point to have in mind is that although transparency rules are different between

bonds and shares the price to pay for a large part of the bond market could be inferred by relatively easy calculation, so that any significant deviation from this value could be identified as mispriced, even by a retail client.

Concretely, to find the way through this complexity, the bond market is structured around specialised dealers that are in a position to arrange transactions. In Europe according to CEPR surveys² spreads are currently very thin, which is the sign of a healthy market, thus we would question the application of new transparency rules. What benefits will they bring? Wouldn't prices go up to take account of the implementation costs, wouldn't some competitors exit the market and thus make it less transparent and efficient...?

We hope to have illustrated the differences for one of the most basic instrument beside shares. Regarding more esoteric markets one could find further differences beyond the ones identified here but one have to bear in mind is that these other markets are mainly for professionals that are satisfied with the available tools. Therefore we wonder if it is a goal of the European Commission to allow retail customer to have access to Swap derivatives?

11. *Q13. To the extent that you have identified problems or believe others might do so, do you agree that only EU-level action would be appropriate in the present case?*

We have not identified any major problem. Some problems identified i.e. Parmalat, Argentina, Enron... would not have been solved by other transparency requirements. None of these cases would have been avoided thanks to pre or post trade transparency whatever the level or type. To solve these issues, we believe that conduct of business rules envisaged in MIFID would create more benefits than any amendment on transparency.

Then depending on issue to be solved, a trade off should be made between action at EU level and action at national level, it should depend on the problem itself, scope and likelihood of its spreading in other Member States.

12. *Q14. If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?*

We tend to think that the FSAP has created a completely renewed environment for the whole EU community, its various measures (Directives on Prospectus, Market Abuse, MIFID...) were created to solve potential problems like facility of trading crossborder, access to financial investment services... Following MIFID implementation, markets will evolve, the impact of this new environment should thus first be assessed in the real world before producing new rules that have the potential to disrupt current equilibrium or at least to remove incentive for innovation.

13. *Q.15 in respect of both pre- and post- trade transparency, are the four options the right ones to consider, and in particular should other options be considered?*

Options identified are perhaps not exhaustive, nevertheless they represent at first sight a set of potential ideas, but the question remains on the necessity of amending current transparency requirements.

14. *Q.16 Would you, in light of your answer to the other questions, favour any of the four options in relation to pre- and post- trade transparency (or another option you might propose for consideration) in respect of transactions in any of: cash government bonds, corporate bonds, high yield corporate bonds, asset backed securities, credit default swap...*

Our preferred approach would be at least in a first time to let the market come with its own solutions. Post-MiFID implementation, markets will evolve quickly, and solutions will arise in due time when needed. Solutions imposed without a wide consensus should be carefully

² CEPR, European Corporate Bonds Markets: transparency, liquidity, efficiency, May 2006
CEPR, European Government Bonds Markets: transparency, liquidity, efficiency, May 2006

planned. Having said this we would opt for “option 1” which for us means to let the market choose its own best path. That should not be confused with doing nothing.

15. For answers to questions 3, 4, 5, 6, 8, 9, 10, 11, 12 we would like you to refer to the FBE - European Banking Federation - position paper.

Conclusion

16. Because markets are efficient, function well and users are satisfied, we do not think there is a need to extend MIFID transparency requirements to other instruments than shares.
17. Doing this would create more damage than solve anything, furthermore markets are so different that any extension of pre or post trade transparency should be carefully assessed and be subject to a rigorous cost benefit analysis. Currently, even if the idea of creating subsets of products and tackle them step-by-step is theoretically a sound procedure, we have not identified yet any concrete need to change current rules on pre or post trade transparency.

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